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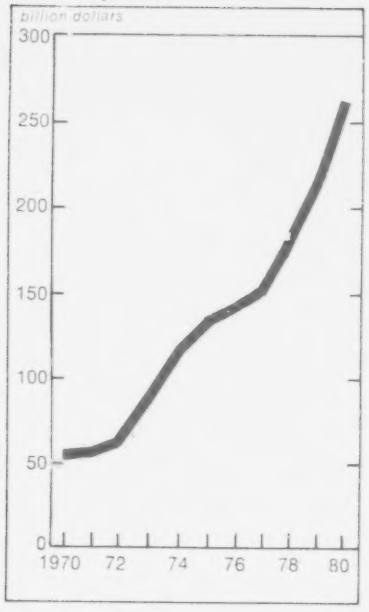
Weak World Economy Behind U.S. Export Slump

A great deal of concern is being expressed about the impact of the recent bout of dollar strength on the U.S. trade position. And demands for increased protectionist policies at home, as well as export subsidies to offset the dollar's strength, will likely become focal points for debate next year. Imports aside, concern over the United States' ability to compete abroad is likely to mount as U.S. export growth continues to deteriorate over the next few months. Available data appear to be supporting these worries: merchandise export growth in 1981 is estimated at only 7½-8%, compared with almost 30% in 1979 and 20% in 1980, and no recovery is seen until late 1982. The key question is whether it is indeed the recent strength of the dollar that is primarily responsible for the current slump in export sales.

U.S. exports



A strong dollar may well influence U.S. exports, but it does not appear to be the fundamental cause of the current sluggishness of U.S. foreign sales. The real culprit behind the export slowdown is the pursuit of restrictive monetary and fiscal policies, launched in late 1979 and carried out in 1980 and 1981. The pivotal change in U.S. monetary policy in late 1979 not only ushered in a period of dollar strength, but also precipitated a change in monetary and fiscal policy worldwide. In an attempt to avoid the inflationary consequences of loose fiscal and monetary policies—particularly in an environment of dollar strength—the United States' major trading partners reacted by tightening policy simultaneously, or at least with only a minor lag. The consequent coordination of worldwide monetary policy has thus resulted in decreased world trade, with economic growth in Europe, the United States, and the developing world taking a back seat to the fight against inflation.

The slowdown in global economic growth, then, is the main cause of the weakness in U.S. exports. The implications of currency fluctuations for the growth of world trade, despite popular beliefs to the contrary, are still not fully understood. The lesson that has been learned from the experience of the past decade is that currency fluctuations are, for the most part, results of policy actions that may or may not affect trade—but are not necessarily the primary causes of trade cycles.

1981—Economics Group, The Chase Manhattan Bank, N.A.

Determinants of sterling strength point to renewed U.K. economic growth.

Sterling has been extremely volatile in recent weeks, but the latest trend has been toward strength—with the pound rising from $1.86 at the start of November to $1.93 on November 25. Although some of this strength was the result of dollar weakness, sterling has also risen against the German mark. Much of sterling's vigor stems from the realization that the Thatcher government intends to stick with its restrictive policies. With the money supply still growing well above target, interest rates are thus likely to be kept high. Indeed, the Bank of England has been operating in the money markets to hold up interest rates in the face of sharp rate falls abroad. This has contributed to sterling's rise, but other influences are also at work. Balance-of-payments figures are being published once again, and September and October showed surpluses of £147 million and £316 million, respectively. These figures, together with surpluses recorded for January and February (the only other months for which figures have been published), suggest that Britain could post a surplus of some £5 billion for 1981 as a whole. A moderation in long-run inflationary pressures is also bolstering the pound. Wage increases averaged 11.1% in August and September, and there are signs that settlements in the current wage round will result in single-digit increases. Moreover, the cost of raw materials and fuels remained constant in October, and only small increases are seen for the near future. Thus, single-digit inflation in 1982 is a strong possibility. Many observers feel that the economy has reached a turning point. The government's policies to date have imposed a high cost in terms of reduced output and increased unemployment, but prospects for renewed growth coupled with relatively moderate inflation are now quite favorable.

Limits seen to Switzerland's tight money policy.

The restrictiveness of Swiss monetary policy since early September largely explains the recent strength of the Swiss franc vis-à-vis the German mark. The principal aim of the tighter money stance is to curb inflation—now running at over 7%—and current policy is indeed seen as consistent with this objective. Two factors, however, will temper the monetary authorities' resolve. First, the Swiss economy is entering a sharp contraction, which will persist well into the first half of 1982. Further Swiss franc strength would seriously impair export competitiveness and deepen the recession. Consequently, the central bank is expected to intervene to check any further climb in the exchange rate. Certainly, any move by the German Bundesbank to ease its monetary stance would be followed swiftly by a similar move in Switzerland. Second, the strength of the Swiss franc in terms of the dollar has already contributed to easing inflationary pressures. Although short-term influences may push the inflation rate higher, the outlook for inflation should be greatly improved in the first half of next year.

Dutch government funds new job-creation program.

With the latest official forecasts indicating real GDP growth of only 1.5% in 1982—following a contraction this year—and another large climb in unemployment, Holland's new government has consented to fund a job-creation program. The newly formed left-center coalition government has agreed to spend an extra 2 billion guilders for jobs, to be financed with a one-time rise in taxes and increased borrowing. The original goal of reducing the public-sector borrowing requirement to 6.3% of national income in 1982 from 8% in 1981 will therefore go unmet. Since about half of Dutch output is exported, however, developments elsewhere in Europe, rather than Dutch fiscal policy, will hold the key to fluctuations in aggregate demand and real GDP growth. On these grounds, a marked upturn in export demand—and thus in economic growth—is not expected before late 1982.

El Salvador's civil turmoil undermining economy.

El Salvador's civil war has taken a heavy toll on the economy. Last year, real GDP contracted by about 10%, with investment plunging by more than 60%. Construction and industry suffered the greatest losses, each dropping by 18%, while agricultural production fell 7%. In the external area, the current-account balance shifted into a deficit of $50 million, after having recorded a surplus of $130 million in 1979, and international reserves totaled less than $80 million at

end-1980. Future economic prospects depend critically on political developments, which at this point promise further economic deterioration. Already, industry and transport have been severely disrupted by acts of sabotage, and concern is high that similar acts will be directed at agriculture as the harvesting of the country's major cash crops gets under way. Even apart from such worries, however, crop prospects for the 1981-82 harvest are poor because of reduced plantings, neglect of field work, and scarcity of credit and foreign exchange. Indeed, the 1981-82 coffee and cotton harvests are expected to be 10% and 30% smaller, respectively, than their previous year's low levels.

Worker remittances represent vital inflows for South Asia.

Since the mid-1970s, there has been a significant migration of labor from the countries of South Asia to the oil surplus countries of the Middle East. This emigration has resulted in a decline in productivity as experienced and skilled workers leave South Asia for higher pay. On the other hand, remittances from workers overseas have become a key source of foreign exchange and an important addition to household income and expenditure in South Asia. In the case of Pakistan—a fairly representative one—remittances now exceed disbursements of foreign assistance. Indeed, at $2.1 billion in fiscal 1980-81, Pakistani remittances were equivalent to 75% of export earnings and to more than 38% of imports. The future trend of remittances for the South Asian nations is highly uncertain, depending as it does on the oil earnings and political stability of the countries of the Middle East. The softness in oil markets may foreshadow an easing in the rate of growth of remittances. Such a slowdown, which appears likely, could have a significant balance-of-payments impact on the economies of South Asia.

Bottlenecks constrain Zimbabwe's economic growth; ample foreign aid a help.

After posting 9% real growth in 1980, the Zimbabwe economy is pressing up against serious foreign-exchange, transport, and skilled-labor constraints. These limitations point to a reduction in the economic growth rate to about 6% for 1981 as a whole. At the same time, upward pressure on prices has built, with the year-over-year inflation rate approaching 20%. In the external sector, stagnant export revenues and increased imports will swing the 1981 trade account into deficit by some $150 million from its traditional position of surplus. As a result, last year's $273-million current-account shortfall could widen to $675 million in 1981, leading to a tripling of the deficit in the overall balance of payments to an estimated $375 million. Resumption of faster economic growth and improvement of the trade account will have to await alleviation of transport problems and economic recovery in Zimbabwe's export-market economies. Meanwhile, the $1.8 billion in foreign aid and grants pledged by international donors should offer much-needed relief to the balance of payments through mid-1984.

A record wheat crop suggests near-term price softness.

World wheat production is expected to set a new record this year, despite the third consecutive year of poor harvests in the Soviet Union and dry growing conditions in the Southern Hemisphere. The U.S. Department of Agriculture projects the 1981-82 crop at 448 million metric tons, with significant rises in U.S. and Canadian output offsetting smaller harvests elsewhere in the world. World consumption is forecast at 446 million metric tons—up only slightly over 1980-81—owing to a substantial slowing in the growth rate of consumption of wheat as a food staple. With total consumption seen falling below production for the year, world stocks are expected to increase slightly after two years of decline. However, ending stocks as a percent of utilization, at 16.8%, will be only marginally higher than last year. This is still well below the 21% average stock-to-use ratio of the latter half of the 1970s. The United States will bear the major part of world wheat stock adjustment as it is expected to provide half of total world exports. With the United States thus serving as "residual supplier" of wheat worldwide, U.S. supplies will be critical to wheat price movements. Prices appear likely to remain weak in the near term, particularly in view of current prospects for a bumper crop of U.S. winter wheat. Prices could begin to strengthen later in 1982, however, as U.S. stocks are drawn down.

New Tax Law May Reduce Business Borrowing

Although the main purpose of the new tax legislation is to provide greater incentives for capital formation, its immediate impact may be to influence corporate borrowing. As inflation has risen steadily over the past decade, the average corporate debt ratio (i.e., debt to total assets) of manufacturing firms has jumped from about one-third prior to 1970 to over one-half today.

The notion that firms tend to borrow more during inflationary periods is generally recognized, although the reason for this behavior is often misunderstood. One frequently overlooked explanation is that increased borrowing may be a conscious strategy to offset the adverse impact of inflation on the real value of corporate cash flow brought about by historical cost-based depreciation allowances. Given the validity of this hypothesis, the accelerated cost-recovery provision of the new tax legislation should serve to reduce corporate borrowing. And in view of the current weakness of the economy and the vulnerability of highly leveraged firms to downturns in earnings, this would be a positive development.

The most prevalent explanations for why corporations borrow more during inflationary periods are misconceived. Perhaps the most popular is that borrowers can benefit by repaying their loans with "cheaper" dollars, or, alternatively stated, in real terms they can borrow at below-market rates. What this argument neglects, however, is that lenders also anticipate the inflation rate and incorporate a compensating premium in the contractual interest rate, thereby removing the inflation-induced incentive to borrow. A second related argument is that, since neither party can predict the inflation rate with certainty, the inflation premium, after the fact, may fail to compensate the lender fully for the loss in purchasing power. But since both parties presumably learn from their mistakes over time, contractual interest rates should not systematically overestimate or underestimate the realized inflation rate.

A third popular, but incomplete, explanation rests on the observation that contractual interest rates represent an average of inflation expectations over the life of bonds. Thus, if corporations borrow when inflation is expected to accelerate, their borrowing costs will include an average of a lower, near-term inflation premium and a higher, long-term premium. Consequently, they will benefit in the long term when they are paying the lower average rate after the inflation rate has risen. The flaw in this argument, however, is that the average of the inflation expectations in the contractual interest rate will also overstate the inflation rate in the near term, offsetting the future savings.

If these justifications do not adequately explain the

Asia and Oceania — Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE O				
			5 months ending	12-month change	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use cred lions
Asia	Bangladesh	Development spending likely to be cut to prevent large budget overrun.	May	+10%	10.6*	$ 119	Sept.	148	— 16%	0.8	3
	Burma	Oil output has recovered to about 27,500 barrels per day.	July	— 3%	5.6*	174	Sept.	245	— 14%	7.3	
	China, People's Republic	Strong growth of light industry offsets decline in heavy industrial production.	June	+15%	242.2	246	June	3,822	+ 10%	2.4	5
	Hong Kong	Government budget in surplus owing to strong manufacturing and real estate growth.	Sept.	+22%	21.5	4,290	n. a.	—	—	—	
	India	Largest loan in IMF history, for SDR 5 billion, approved.	June	—17%	172.6*	257	June	5,853	— 17%	5.8	3
	Indonesia	Oil production slows; good rice crop boosts rural income.	Mar.	+ 9%	66.3	437	Sept.	5,560	— 1%	5.2	
	Japan	Consumer spending signals revival, but small business investment and housing remain weak.	Aug.	+19%	1,044.0	8,940	Sept.	27,634	+ 20%	2.3	
	Korea	Government likely to adjust investment priority to finance 1988 Seoul Olympics.	Aug.	+26%	57.8	1,513	Aug.	2,023	— 39%	0.9	1,0
	Malaysia	Increased government spending and new business incentives proposed to spur economy in 1982.	June	—13%	22.8	1,697	July	3,994	— 6%	4.3	2
	Pakistan	Government pledges measures to restructure revenue system this year.	June	+23%	25.6*	311	Sept.	778	+ 71%	1.7	5
	Philippines	Local housing market depressed by recession and high domestic interest rates.	June	+10%	35.1	726	Sept.	2,010	— 19%	2.9	9
	Singapore	GDP growth slowed to annualized rate of 9.7% in third quarter, led by construction.	July	+ 8%	10.5	4,390	June	6,721	+ 8%	3.0	
	Sri Lanka	Government revamps turnover tax and extends its coverage to raise revenue.	May	— 3%	4.1	280	Sept.	237	— 30%	1.6	3
	Taiwan	Government takes measures to stimulate business investment.	Aug.	+13%	40.2	2,278	June	3,339	+124%	1.8	
	Thailand	Growth will slow as new five-year plan seeks to redress structural imbalances.	July	+10%	32.2	693	Sept.	1,393	— 33%	1.6	4
Oceania	Australia	Labor market turmoil continues; skilled labor immigration actively sought.	Aug.	+ 1%	138.2	9,454	Sept.	1,609	+ 20%	0.7	
	New Zealand	Some mineral projects being delayed because of anticipated cost overruns and upcoming election.	July	+ 8%	21.2*	6,714	Sept.	342	— 3%	0.7	
	Papua New Guinea	Ok Tedi copper and gold project under way.	June	—35%	2.5	820	Sept.	379	— 17%	4.3	

*Fiscal year

observed relationship, the question still remains as to why firms tend to increase their borrowing in response to anticipated inflation. The answer lies in the distortion that inflation brings about in relative prices, since if all prices, including wages, rose at the same rate, economic activity would be unaffected. Specifically, for inflation to influence corporate borrowing behavior, it must affect the values of the elements of corporate cash flow differentially. In fact, two affected elements—depreciation allowances and repayments of bond principal—are fixed institutionally in nominal terms and cannot adjust freely to inflation in the way that wage costs often do.

Depreciation is a non-cash expense that is deductible for tax purposes, resulting in a positive cash flow. Since its magnitude is limited by the historical cost of plant and equipment, its relative value in real terms declines with inflation. Moreover, because of the failure of this positive cash flow to rise with inflation, there is a tendency for total corporate cash flow to decline in real terms. In the absence of any countervailing force, this development would serve to discourage investment activity, harming the economy as a whole. Fortunately, two countervailing forces are now at work. The most obvious is new tax legislation, which boosted depreciation allowances by shortening the useful lives of assets for tax purposes. The other, which firms have been utilizing for some time, is increased borrowing.

Borrowing is an effective strategy for offsetting the adverse impact of inflation on tax-related depreciation cash flows because bonds are issued in fixed denominations. Accordingly, when lenders seek to recover the real purchasing power of their principal, they must include the inflation-related portion in the contractual interest rate. Since the firm then deducts its interest payments for tax purposes, it receives an inflated tax-related interest benefit. Consequently, although depreciation does not keep pace with inflation, interest payments rise faster, so that the overall impact of inflation on total corporate cash flow is neutralized.

This hypothesis has important implications for the probable impact of the new tax legislation on corporate behavior. By recourse to debt financing, corporations have insulated themselves from the adverse effects of inflation. However, borrowing is not without its costs, and the excess reliance on debt has exposed firms in the current economic environment to an increased risk of financial difficulty. Now Congress has provided a safer alternative for preserving the real value of corporate cash flow. Although the law's intention was to encourage capital formation, it is reasonable to expect many corporations to use the additional cash flow to retire debt, since excessive leverage is no longer necessary to offset the adverse effect of inflation on depreciation. Although the law may not stimulate as much immediate investment as many expect, its influence in reducing corporate borrowing may be just as beneficial by strengthening corporate balance sheets to withstand the current downturn and prepare firms for future investment.

Carl Alan Batlin

PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				exchange rate in U.S. dollars	change from year earlier		
f IMF mil- dollars	current influences on payments	latest data	consumer prices	latest data	money supply(M1)	December 2, 1981		current monetary conditions	
	Import licenses restricted to conserve scarce foreign-exchange reserves.	July	+14%	June	+24%	.0525	−13%	Steps taken to slow credit growth.	Bangladesh
	U.S. economic assistance of $30 million accepted.	June	− 4%	Oct.'80	+11%	.1360	− 9%	SDR peg will bring kyat appreciation with dollar weakness.	Burma
	Partial Japanese financing arranged for certain Japanese projects in China.	Dec.	+ 8%	June	+26%	.5800	0	Treasury bonds sold to reduce money supply growth.	China, People's Republic
	HK dollar strengthens in response to high interest rates.	July	+15%	July	+ 3%	.1785	−10%	Money market tightens, but credit availability increases.	Hong Kong
	Import liberalization to continue.	June	+14%	May	− 6%	.1100	−14%	Credit conditions to be restrictive under IMF program.	India
	Non-oil exports down; deficit seen for 1981 current account.	Sept.	+10%	June	+34%	.0016	0	Inflation slows because of soft food and oil prices.	Indonesia
	U.S. and EEC pressuring Japan to boost imports.	Aug.	+ 4%	July	+ 7%	.00464	0	Ceilings on overseas loans and on samurai bonds relaxed.	Japan
	Growth of letter-of-credit arrivals slows; foreign investment encouraged.	Aug.	+25%	Aug.	+ 4%	.0015	0	Interest rates lowered one percentage point.	Korea
	Import duties to be liberalized on a variety of goods.	June	+11%	June	+15%	.4454	− 2%	Bank foreign-currency borrowing and lending to be allowed.	Malaysia
	Further measures to liberalize imports likely.	July	+13%	July	+17%	.1020	+ 1%	Credit conditions to continue tight under IMF guidance.	Pakistan
	Trade deficit of $1.98 billion recorded for first nine months of 1981.	Aug.	+12%	July	+11%	.1270	− 4%	Money supply on 15% target growth path.	Philippines
	Heavy capital inflows continue, covering current-account deficit.	Aug.	+10%	June	+11%	.4878	+ 2%	Inflation and interest rates soften.	Singapore
	Depressed commodity prices help widen trade deficit.	June	+18%	June	+ 9%	.0520	− 6%	Depreciation of rupee continues.	Sri Lanka
	Import of petrochemicals liberalized.	June	+18%	June	+13%	.0280	+ 1%	Interest rates lowered; mortgage financing to increase.	Taiwan
	Weak prices depress agricultural export receipts, despite strong volume gains.	Aug.	+11%	Apr.	+10%	.0400	− 5%	Credit conditions slightly easier.	Thailand
	Current-account deficit widening further.	June	+ 9%	July	+12%	1.1460	− 2%	Campbell Report seeks sweeping financial liberalization.	Australia
	Export subsidy to be phased out gradually.	June	+15%	July	+ 5%	.8390	−13%	Government to restrict credit growth.	New Zealand
	Export earnings drop further with declining commodity prices.	June	+ 9%	July	−10%	1.4600	− 4%	Money conditions stay tight; IMF loan obtained.	Papua New Guinea

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World Interest Rates

market rates of Dec. 2, 1981; bond yields as of Nov. 27, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	13.00	15.32	14.375 intervention rate	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	6.00	6.25
Day-to-Day Money	12.50 December 3	18.75	15.00	9.60	15.50	11.00	20.375	11.00	5.00	7.375
Treasury Bills 91-day, Middle Rates	10.56 discount basis	15.15	13.9375	14.75	n. a.	n. a.	19.649 87-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	10.875 finance paper discount basis	15.75 finance paper 15% tax w/h	13.42	12.90 Certified	15.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	11.45	15.40 15% tax w/h	14.00	12.90 Certified	not traded	9.90	24.00	no market	9.75	no market
Government Bonds Long-term, new and old issues, average yield	13.10	14.75	14.76	10.74 20% tax w/h	16.09	9.76	21.57	11.35	5.57	7.87
Industrial Bonds prime, long-term, new and old issues, average yield	14.05 Aa Industrials	16.00	15.99	19.725	17.57	9.70	21.15	13.03	6.625	7.10
Bank Short-Term Rate to Best Borrowers (prime rate)	15.75	17.25	16.00	18.00	17.35	14.00	22.50 ⅛ quar'ly fee on outstdng.	13.00	10.50	6.75
Bank Time Deposits 3-month	11.625 Cert. of Dep.	15.00	15.00	14.35	15.375	10.55	10.75	11.375 large deposits	8.75 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	12.8125	no market	15.25	no market	18.00	10.5625	no market	11.50	9.875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8492	1.9545	.0265	.1790	.4521	.000642	.4128	.5630	.00464
Forward Exchange Cover 3-month, *in percent p.a.* *D* = discount, *P* = premium	—	3.00 *D*	2.00 *D*	5.00 *D*	4.50 *D*	2.00 *P*	11.00 *D*	1.00 *P*	3.00 *P*	5.50 *P*

Eurodollar Deposits
(London, interbank, bid)
December 2

7-day	12.75
1-month	12.4375
3-month	12.5625
6-month	13.125

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.186
U.S.-Canada Treasury Bills	−0.839
U.S.-Canada Finance Co. Paper	−1.659
Eurodollars-U.K. Local Auth. Deposits	−0.1875

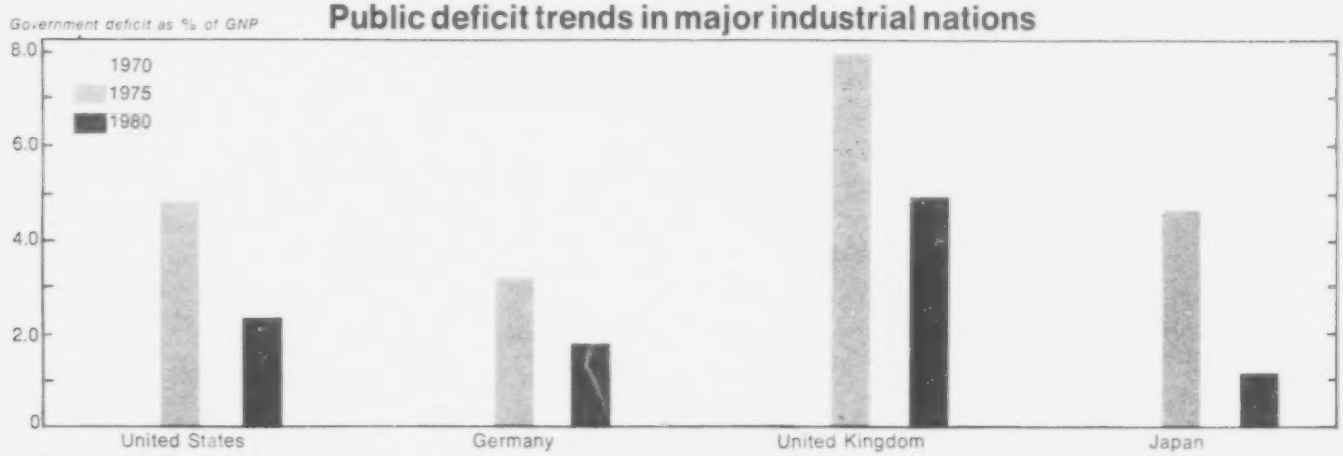
Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	14.50
Over 7 yrs.	14.75
DM Bonds	
7 yrs. and under	9.50
Over 7 yrs.	9.75

Gold Price
London afternoon fixing
406.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Public deficit trends in major industrial nations



Data: International Monetary Fund

The Need for Balance

The following is excerpted from a speech given by **Willard C. Butcher,** *Chairman and Chief Executive Officer of The Chase Manhattan Bank, before the Economic Club of Detroit on November 23, 1981.*

The topic that has dominated the nation's attention since the very first days of the Reagan administration has been its economic package. I have been a supporter of the administration's economic program, although I have not agreed with each specific budget cut or policy nuance. Nonetheless, I do believe that the administration has put together an economic package whose long-term objectives are critical to restoring economic progress.

The problem, in my judgment, comes in the short term. There is simply no way, as President Reagan has reiterated, that this nation can avoid short-term problems of economic readjustment on its way to the longer-term promise of economic reemergence. What is needed in the short term is a carefully struck balance among the four elements of the program—spending cuts, tax cuts, deregulation, and monetary policy—not only to get us safely through this painful interim period, but also to ensure that we do not blunt the positive long-term effects.

In particular, there must be a balance between those aspects aimed at encouraging production and investment and those designed to control the money supply. Indeed, overly restrictive monetary policy—as noble as its inflation-fighting aim may be—could imperil the public's willingness to accept the short-term discomforts that are necessary to regain long-term economic growth.

The administration has offered a logical approach to the twin goals of lower inflation and greater economic growth. Both goals, I believe, are compatible and complementary. Some have erroneously insisted that inflation was an "inevitable companion" of growth; that "a little inflation" was even desirable. Nothing, to my mind, could be further from the truth.

Indeed, nothing is more detrimental to capital development and economic growth than inflation, because it erodes the very capital on which growth is based. And the administration's program implicitly recognizes that the rate of inflation is influenced not only by monetary policy but also by the growth of economic activity.

Monetary policy alone is simply not enough to curb inflation or cure our economic ills. In fact, excessive reliance on monetary policy may exacerbate our problems by dampening investment and inhibiting productivity growth. Moreover, in my view, monetary growth that reflects productive investment and economic expansion does not carry the same inflationary consequences as when money growth feeds consumption. In other words, it seems to me, that in assessing the appropriate stance of monetary policy, we must pay more attention to such factors as interest rates and what I would term the "qualitative aspects" of money flows—namely, the sources and uses of funds, particularly those used for saving and investment and, therefore, economic growth.

This argument was amply demonstrated in the 1950s and 1960s in Germany and Japan. During this period, high rates of monetary growth in Germany and Japan—9% and 12%, respectively—did not spur high inflation because they were accompanied by rapid, real economic growth.

As for the proper rate of money growth, we need to allow the money supply to expand in tandem with the economy and not be a drag on it or a prod to it. In essence, we need a more neutral, more consistent, and more predictable monetary policy.

In this context, if the current reduction in interest rates leads to a steadier monetary posture, then I believe it will prove beneficial in the long run. However, what we must avoid, in my view, is a return to the see-sawing, yo-yoing, roller-coaster rate course that has been such a punishing source of instability to our economy. If we reduce rates too fast and too far, we run a serious risk of a strong reaction—followed, in turn, by sharply higher interest rates. Such a course would be a real impediment to economic recovery.

My conclusion from all this is that embracing a single-minded approach to economic recovery—be it strict monetarism or any other theory—is not nearly as sound as adopting a more balanced and pragmatic approach, which requires judgment rather than dogma. In today's complex environment, any workable economic recovery program must be grounded in a more sophisticated view of the interplay between the money supply and inflation and between the growth in monetary aggregates and the expansion of productive investment.

That is why the other elements of the administration's program—deregulation, spending cuts, and tax cuts—are so critical. They are all aimed at freeing the economy to permit more efficient use of productive resources, which will in turn yield higher growth

The Need for Balance *(continued from page 7)*

rates. And by seeking to encourage faster growth, these other aspects will enlarge the space in which monetary policy can be used to reduce inflation.

Deregulation is one example. Industries that are tightly regulated inevitably use resources inefficiently. They have little ability to do otherwise since the barriers to competition erected by regulations ensure that there will be no penalties for misusing resources. This is the case not only in our own regulated industries, but also in those European countries that have nationalized major industries. The inefficiency of these industries goes uncorrected and their nations' growth rates are constrained. Thus, in the United States, further deregulation should lead, over time, to less constrained economic growth.

The efficient use of our resources will be further enhanced by the second leg of the economic recovery program: *reduced government spending*. Government has tended to seek an ever-increasing portion of our resources for programs that take from, rather than add to, productive capacity. For example, 35% of federal spending is for income-transfer programs that promote consumption at the expense of saving and investment. If our economy is to grow more rapidly, the share of our resources devoted to building up productive capacity must increase. And this can only be achieved if fewer resources are allocated by the government and more are put to work by the private sector.

The third leg of the program, *tax cuts*, is designed to improve the use of resources by transferring economic decisions from the government to individuals. Economic decisions are made on the basis of comparisons between additional costs and additional benefits. High tax rates can alter the relationship between the risks entailed in new undertakings and the potential rewards. We had been embracing an incentive system that offered greater and more certain rewards for current consumption than for long-term investment. Fortunately, the administration's program of tax cuts has changed that equation. But here again, tax cuts must be balanced against spending cuts. We cannot make progress if tax cuts return more decisions to the private sector while increased government spending takes these decisions away.

Without the appropriate balance between tax cuts and spending cuts, the impact of our economic program on productivity and economic growth will be markedly curtailed. And without significant progress in improving productivity and economic efficiency, the potential for monetary control to do its job is severely hampered. Conversely, the more progress that is made in improving the quality of resource allocation, the smaller the burden monetary policy must shoulder in fighting inflation.

To repeat, if we put too much of a burden on monetary policy in the short run, we undermine the potential for growth and the reduction of inflation in the long run. Moreover, if we permit large federal deficits, and stoke the government's need to borrow, the entire short-run burden of adjusting to monetary control falls on the private sector. The federal government's demand for credit is insensitive to cost, so it is the private sector that is "crowded out" of the market because it is unwilling to invest when rates are so high that earning an adequate rate of return becomes improbable. On the other hand, I agree with Herb Stein that "if the private sector comes to expect greater stability in the long run and a stabilized monetary policy in the short run, private investment will itself become more stable and dependable."

Let me not be misunderstood. We will not solve our problems by weakening our resolve to control monetary growth. The last thing we need is "soft money". Rather, the solution lies in a more balanced approach to monetary policy along with deregulation, stricter control over government consumption and borrowing, and a reduced government deficit. And this means further cuts in government spending.

The more progress we make in improving the quality of resource allocation, the smaller the burden that monetary policy will have to shoulder to fight inflation. And with improved resource allocation, the more likely it is that an impatient American public will give the administration the time to demonstrate the wisdom of its economic strategy.

And time is precisely what is needed. Regrettably, now that it appears the United States is undergoing a recession, there is talk that we should cast away the fundamentals of our economic program, restore the spending programs that had been trimmed, and roll back the taxes that were cut. I suspect we will hear more of this talk if, as is expected, unemployment rises. But to heed these suggestions would doom our chances for economic recovery.

Our entire economic program is based on sound and sensible long-term policies for restoring economic health. To abandon any of the principal elements of this program at this time would undermine its credibility, increase economic uncertainty, and deprive our nation of the benefits of the first coherent plan in decades to get us back on the track of growth and productivity.